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REFS: A) BRASILIA 257 B) SAO PAULO 216 C) BRASILIA 478 D) BRASILIA 347

¶1. (SBU) Summary: Brazilian private and public sector interlocutors in Brasilia and Sao Paulo told U.S. Treasury Deputy Assistant Secretary Nancy Lee that Brazil's economic downturn may be bottoming out. Bankers, however, were unwilling to predict when investment levels would trend higher, which many believe would represent the ultimate indication that the economy has turned the corner. Meetings revealed an interest in sub-sovereign IFI lending and in IDB reform to support needed regional infrastructure projects. Finance Ministry interlocutors indicated that they had not excluded possibly contributing via the new arrangements to borrow (NAB) for the IMF, but remained concerned that IMF members stay focused on substantive reform. Brazilian interlocutors agreed that progress on bilateral tax and investment treaties is a political issue and that changes to the transfer pricing system would be difficult, and recommended framing a BTT as a stimulus to economic growth. A roundtable discussion with political/economic observers commented on the unlikelihood of major economic reforms before the 2010 elections and on economic policy under various potential future leaders. End Summary.

¶2. (U) On May 12 and 13 Treasury Western Hemisphere DAS Nancy Lee met in Sao Paulo with the small and medium enterprise (SME) division of HSBC Bank, Itau Bank's Chief Global Economist, the Brazilian Investment Association (SOBEET), Sao Paulo Governor Serra's Chief Economic Adviser, and participated in a roundtable with EXIM Chief Operating Officer John McAdams and senior bankers including presidents from the Brazilian operations of Goldman Sachs and HSBC. In Brasilia, she met with the President of APEXBrasil (Brazil's export and investment promotion agency), former Brazilian Minister of Finance and current Congressman Antonio Palocci, Finance Ministry Undersecretary for International Affairs Marcos Galvao and Fazenda Chief of Staff Luis Melin, and Minister and Presidential Advisor for Strategic Affairs Mangabeira Unger. Lee also participated in a roundtable with local political and economic observers, including head of the Chamber of Deputies Legislative Consultancy Ricardo Rodrigues, Valor journalist Sergio Leo, University of Brasilia Professor David Fleischer, and political analyst Thiago Aragao from Arko.

ECONOMIC OUTLOOK

¶3. (SBU) The prevailing view among bankers in Sao Paulo is Brazil is showing some signs of recovery, is in relatively better condition than other major economies, and will recover sooner than developed and other emerging countries. The Executive Director and head of SME lending for HSBC in Brazil, Walter Oti Shinomata, whose sentiment closely mirrored other bankers on DAS Lee's schedule, said that Brazil was nearing the bottom of the economic downturn. Shinomata cautioned, however, that he was not confident Brazil had

entered into a definite recovery pattern. Only John Welch, Itau Bank's Chief Global Economist, declared that Brazil was indeed pulling out of the economic downturn, saying, "the recovery has already started ... in the second half of the year, you will start to see it." Welch, like other meeting participants, remained concerned with continuing weak investment activity, but remarked on two recent corporate bond issuances as evidence that economic fundamentals had begun to improve. That said, Welch called positive economic growth in 2009 a mathematical impossibility (Note: The Central Bank survey of financial institutions predicts negative .49 percent growth in 2009; the investment bank community range closer to negative 1.5 percent).

¶4. (SBU) During the bankers' roundtable, HSBC Brazil President Shaun Wallis provided background perspective to explain the prevailing higher levels of optimism that Lee encountered in Brazil relative to other economies. He praised government action for intervening early with liquidity injections in the credit market, including targeted trade credit support, to soften the impact of the global crisis in Brazil. He also referenced Brazilian structural economic factors that limited negative global exposure, including: diversified trade, net exports representing only two percent of GDP, and only minimal dependence on foreign credit. Finally, to demonstrate Brazil's insulation from the harmful impacts of excessive leveraging, Wallis pointed out that only four percent of privately-owned homes in Brazil carry financing.

¶5. (SBU) None of the Sao Paulo interlocutors was willing to speculate when investment levels would trend towards pre-crisis levels, yet the general consensus was that investment levels had to increase before Brazil could safely enter into a recovery period. In Brasilia, Ministry of Finance International Affairs Secretary

Marcos Galvao said that portfolio investment was returning to Brazil since the flight to quality earlier in the crisis, but that other issues were still impeding investment growth, most notably economic prospects in China and the rest of the world. Even Itau's Welch, the lone analyst who told Lee that Brazil was in a recovery mode, explained that the current interruption of investment spending has already taken a full point off of Brazil's future GDP growth rate. As a direct result, Welch estimates out year (post-crisis) GDP growth in the four percent range, down from the five percent pre-crisis trend.

INFRASTRUCTURE

¶6. (SBU) A reoccurring view raised during DAS Lee's meetings is that infrastructure spending in Brazil is still lagging behind acceptable levels. Leaders from SOBEET as well as the members of Sao Paulo Governor's economic team blame much of the problem on a burdensome bureaucracy established by politically motivated regulatory bodies. This institutional environment, they contended in their separate meetings, was to blame for the lack of significant progress in the Growth Acceleration Program (PAC), Brazil's ambitious infrastructure development plan.

IDB LENDING AND MANAGEMENT

¶7. (SBU) A number of officials raised concerns regarding both the current management of the IDB and IDB efficiency in working with the private sector and in supporting projects in the region. Alessandro Teixeira, President of APEXBrasil, said that 35 percent of IDB funds are spent in Brazil -- funds that the Brazilian Development Bank (BNDES) gladly accepts as cheap money, but as Teixeira explained, also create a source of contention among developing economies in the region. Teixeira also stressed feedback he has received from the business community that IDB is difficult to penetrate and does not make it easy for commercial operators to work with the institution. Teixeira explained that private sector participation is required to develop additional infrastructure projects, but that private enterprise considers the IDB too bureaucratic. Teixeira and Palocci both expressed concerns that IDB, in its current form, is lacking institutional capability. Teixeira and Palocci indicated

dissatisfaction with IDB management. Teixeira was especially forthcoming in describing his lack of confidence in IDB President Luis Alberto Moreno's ability to manage the IDB.

¶8. (SBU) Francisco Luna, Chief Economist to Sao Paulo Governor Jose Serra, said the state of Sao Paulo currently borrows from the World Bank, IDB and the Japan Bank for International Cooperation (JBIC), and could use as much financing as development banks are willing to extend. Sao Paulo state is particularly interested in directing these resources towards infrastructure projects, notably transportation projects in and around the city of Sao Paulo. Luna lamented that the MDBs do not currently have enough money to meet demand, and that MDB regulations combined with Brazil's own slow bureaucracy create burdensome project lags.

IMF Reform and NAB

¶9. (SBU) In Brasilia meetings, DAS Lee emphasized U.S. Treasury's desire to continue with IMF governance reform while supporting current expansion of the new arrangements to borrow (NAB). As previously reported (REF C), Galvao indicated that Brazil remains committed to an IMF contribution, and has not ruled out the option of contributing via the NAB, but remains concerned that funding under the existing NAB mechanism could undermine progress toward substantive IMF governance reform. (Note: Brazil's NAB contribution, if made, would occur via bond issuance rather than an appropriation. This will allow GOB to label the transaction a form of reserve management and thus can sidestep the Congress, where political opposition is likely. End Note). DAS Lee emphasized that the USG remains committed to governance reform and said that it is in Brazil's interest to take part in the NAB augmentation.

¶10. (SBU) Galvao again conveyed GOB satisfaction with the G20 process generally and the US approach to consensus-building, welcoming that the US will host the next G20 meeting in the fall.

BILATERAL TAX AND INVESTMENT TREATIES

¶11. (SBU) Meeting participants agreed on the necessity and advantages of establishing bilateral tax and investment treaties with the United States, yet confirmed that the familiar roadblocks

that have hampered real progress for years remain intact. Both Teixeira and Palocci asserted that progress on bilateral tax and investment treaties required intervention at the highest political levels, and both pledged they would raise the issues accordingly within the Brazilian government.

¶12. (SBU) Teixeira described a Brazilian business community becoming more engaged in international transactions and therefore applying greater pressure on the government to make progress on tax and investment treaties. Teixeira was responsive and accepting of DAS Lee's comments that tax treaty negotiations were hung up on Brazilian inflexibility over transfer price and dispute resolution, and said he would specifically mention these sticking points with President Lula. Palocci indicated that changes to the Brazilian transfer pricing system would be politically difficult and also pledged that he would raise the issue of tax and investment treaties with Finance Minister Mantega. Palocci suggested a strategy of using economic arguments to counter tax revenue concerns. An independent study, Palocci postulated, analyzing the long term benefits a tax treaty would have on economic growth and tax proceeds would be helpful in this respect. Congressman Palocci concluded that a mandate from Lula and Mantega directing Receita Federal(IRS-equivalent)to engage productively could produce a proposal acceptable to the Brazilian legislature.

BRAZILIAN POLITICS AND U.S. - BRAZILIAN RELATIONSHIP
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¶13. (SBU) In Brasilia, DAS Lee attended a roundtable with political/economic observers. Participants offered views on Brazil's 2010 elections and Lula's presidential pick Dilma

Rousseff's cancer diagnosis, which casts a new layer of uncertainty over the probability of a Rousseff and Sao Paulo Governor Serra contest. Analysts believed economic policy would remain roughly similar to the Lula administration's under a potential Rousseff or Serra administration. Observers complimented Lula's approach, saying that he knows he does not have a deep understanding of economic issues, so tends to listen thoughtfully to his advisors, weigh opposing viewpoints, and make careful decisions. In contrast, these analysts thought that Serra might tend to overly respect his own judgment on economic issues, which potentially could lead to decisions that do not fully consider all factors. On foreign policy, participants felt Ministry of External Relations might become more influential in policy-setting under a Rousseff administration, while Serra might display a tendency to "look inward" and potentially pull back from increased international engagement. All agreed now is too early to know for sure who the Presidential candidates will actually be because Rousseff's health issues or a heretofore unknown scandal emerging regarding one of the top four or five candidates or their associates could significantly change the field before the election season begins. Participants also agreed that major economic reforms, such as tax or labor reform, all of which would be politically challenging, would be unlikely to be proposed or to move forward before the 2010 elections.

¶14. (SBU) The U.S. - Brazilian relationship was discussed in broad terms in DAS Lee's meeting with Minister and Presidential Advisor for Strategic Affairs Mangabeira Unger. While no specifics emerged from the meeting, Unger described his view of an amplified U.S - Brazilian strategic relationship, and suggested the U.S. Government name a counterpart position to his to direct the new relationship from the U.S. side. He proposed that biofuels, SMEs, and education could serve as examples, not necessarily priorities, of areas to target for collaboration.

¶15. (SBU) Comment: While the official government sector has consistently been more optimistic than the private sector with respect to future economic growth, DAS Lee's visit showed that Brazil's public and private sector are aligned in their view that Brazil is poised for an economic recovery. On the IMF, interlocutors did not exclude the possibility of considering a NAB contribution, but continue to worry about maintaining focus on governance reform. Interlocutors' concerns regarding IDB management, particularly given Brazilian interest in regional infrastructure development, were striking. End Comment.

¶16. (U) This cable was coordinated/cleared by the U.S. Treasury Attache in Sao Paulo and Consulate Sao Paulo.

KUBISKE